No. 22070

In the

United States Court of Appeals

For the Ninth Circuit

FRED W. ALKIRE AND LOIS O. ALKIRE,
Appellants,

vs.

ROBERT A. RIDDELL,
Appellee.

On Appeal from the United States District Court for the Central District of California

APPELLANT'S OPENING BRIEF

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INTRODUCTION

This appeal presents a question which for the past several years has been the subject of repeated litigation in the federal courts and the Tax Court. The question is: When will payments based upon the quantity of material extracted from a mineral deposit be considered ordinary income, and when will they be taxed as proceeds from the sale of a capital asset. Although the question has been before it many times, even the Supreme Court has not achieved uniform and harmonious results in the situations

it has passed upon; and the federal courts of appeal and Tax Court have groped for principles which should determine the correct result, coming up with widely divergent views and arriving at decisions which are difficult, if not impossible, to reconcile.

This Court has most recently considered the question in *Gowans* v. *Commissioner* (9th Cir. 1957) 246 F.2d 448, but then on a somewhat unique set of facts. This appeal, therefore, presents to this Court the opportunity to establish some bright lines in this area of uncertainty, rather than to join some of the other courts which, unfortunately, have drawn "gossamer lines" and based their decisions on distinctions "which hardly can be held in the mind longer than it takes to state them."[1]

JURISDICTIONAL STATEMENT

This is an appeal from a judgment entered on March 20, 1967, by the United States District Court for the Central District of California in favor of the defendant (appellee herein) and dismissing with prejudice the plaintiffs' (appellants herein) complaint for refund of income taxes [CT 93].[2] The underlying action was brought by appellants under the authority of the Internal Revenue Laws of the United States, and the District Court's jurisdiction was invoked under 26 U.S.C. 7422, 28 U.S.C. 1340, and 28 U.S.C. 1346. Venue was determined under 28 U.S.C. 1391 [CT 2; Amended Findings of Fact Nos. 1, 2, 3, 4, 5, 6 and 7, CT 130-131; Amended Conclusion of Law No. 1, CT 135]. The appellants on March 28, 1967, filed a Motion for Amendment of Findings, for Additional Findings and for Special Finding, pursuant to Rule 52 (b) of the Federal Rules of Civil Procedure [CT 100-101]. Amended Findings

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1. Concurring opinion of Justice Frankfurter in *Burton-Sutton Oil Co.* v. *Commissioner* (1946) 328 U.S. 25, 37-38, 90 L. Ed. 1062, 1070, 66 S.Ct. 861.

2. References preceded by the capital letters "CT" are to the Clerk's Transcript of Record. References preceded by the capital letters "RT" are to the Reporter's Transcript of Proceedings. The judgment, apparently through a clerical error, refers to the years in issue as 1958, 1959, 1960, and 1961, whereas in fact the years in issue are 1959, 1960, 1961 and 1962.

of Fact and Conclusions of Law, and an Order Denying Request for Special Finding were thereafter filed on April 18, 1967 [CT 129-138]. The appellants on June 14, 1967, filed a timely Notice of Appeal under Rule 73(a) of the Federal Rules of Civil Procedure [CT 139-140]. This Court's jurisdiction rests upon 28 U.S.C. 1291.

STATEMENT OF THE CASE

This is a suit brought by Fred W. Alkire and Lois O. Alkire for a refund of Federal income taxes and interest thereon paid by them for the years 1959, 1960, 1961 and 1962, and for such additional interest as is provided for under 28 U.S.C. 2411(a). [Amended Finding of Fact No. 1, CT 130][3]

The Facts of This Case

On December 7, 1954, a lease (the "December lease" herein) was entered into between The Irvine Company, a corporation ("Irvine" herein), lessor, and the taxpayer, lessee, covering approximately 19.4 acres in the Santa Ana Canyon, Orange County, California. Said lease provided that for a period of fifteen (15) years, or until such time prior thereto as in lessee's judgment it would no longer be profitable to take and remove the materials covered by the lease in commercially paying quantities, the lessee would have the sole and exclusive right to extract, take and remove from the leased premises soil, rock, sand, gravel, and other earthly materials suitable for use in road and highway construction. The lessor's written consent was required before taxpayer could assign the lease or any right or interest therein or in or to taxpayer's business operations on the leased premises [Ex. I; Amended Finding of Fact No. 16, CT 133].

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3. Lois O. Alkire is a party only by virtue of having filed joint returns with her husband. She has played no active part in any of the business transactions relevant to the resolution of this controversy. Fred W. Alkire will be referred to herein as "the taxpayer".

Taxpayer entered into possession of the leased premises on December 7, 1954, and commenced his sand and gravel business operations thereon on December 15, 1954 [Amended Finding of Fact No. 16, CT 133].

On or about March 31, 1955, taxpayer was approached by Mr. E. O. Rodeffer[4] who wished to purchase taxpayer's leasehold estate under the December lease, together with taxpayer's rock crushing plant, truck scales, and leasehold improvements located on the leased premises and used by taxpayer in his sand and gravel business [RT 127-130; 179-180; Exs. 3 and 4]. The taxpayer was insistent that he would not sell his leasehold without at the same time selling his machinery, equipment and leasehold improvements; and Rodeffer was equally adamant that he would not purchase the machinery, equipment and leasehold improvements without the leasehold [RT 183, lines 23-25; 184, lines 1-3; 136, lines 1-5]. The parties, therefore, at all times negotiated for the sale and purchase of the sand and gravel business operation as a whole.

Following negotiations, taxpayer and Rodeffer on May 5, 1955, executed certain "Bulk Sale Escrow Instructions" addressed to Union Bank & Trust Company wherein it was provided that the rock crushing plant, truck scales and leasehold improvements would be purchased by Star Rock Products, Inc. for Sixty Thousand Dollars ($60,000.00) cash, (allocated $50,000.00 to the rock crushing plant, $7,000.00 to the truck scales, and $3,000.00 to the leasehold improvements) if (i) Irvine's approval of the transfer of taxpayer's business operation could be secured and (ii) a new variance permit could be obtained from the County of Orange [Ex. 6]. On May 27, 1955, the parties executed

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4. Mr. Rodeffer was the sole stockholder and President of Star Rock Products, Inc., a California corporation [Amended Finding of Fact No. 8, CT 131; RT 122, lines 10-11; 123, lines 2-4]. In 1960 Star Rock Products, Inc. was merged with eight other corporations in which Mr. Rodeffer owned 100% of the stock, and the name of the surviving entity was changed to Rodeffer Industries, Inc. [Amended Finding of Fact No. 10, CT 131]. For ease of reference, Mr. Rodeffer, Star Rock Products, Inc., and Rodeffer Industries, Inc. will sometimes herein be referred to collectively as "Rodeffer".

an Agreement which provided that taxpayer would surrender to Irvine his December lease in exchange for a new lease from Irvine naming taxpayer and Rodeffer as co-lessees, covering the same property and containing substantially the same terms and conditions; and that upon execution and delivery of the new lease to taxpayer and Rodeffer, the new lease would be assigned by them to Star Rock Products, Inc. The Agreement further provided that from and after the effective date of such assignment, and for so long as Star Rock Products, Inc. continued its operations and produced rock from the leasehold, Star Rock Products, Inc. would pay to taxpayer a "royalty" of leasehold and sold by Star Rock Products, Inc. [Ex. 5]. Three Cents (3¢) per ton of material produced from said The "royalty" was in lieu of a cash sum for the taxpayer's leasehold interest in the deposit, since such a lump sum would have been well beyond the ability of Rodeffer to pay [RT 141, lines 4-25; 142, lines 1-18].

The transaction was handled by means of separate agreements (i.e., the May 5, 1955 Escrow Instructions [Ex. 6] and the May 27, 1955 Agreement [Ex. 5]) because Rodeffer needed to borrow the Sixty Thousand Dollars ($60,000.00) from the Union Bank and had agreed to give the Bank, as security for the loan, a chattel mortgage on the machinery and equipment which he was purchasing from the taxpayer. The Bank and Rodeffer, therefore, were vitally interested in seeing to it that Rodeffer received clear title to the machinery and equipment so that the Bank's chattel mortgage would be a first lien; and thus the phase of the transaction which concerned the machinery and equipment was handled through the escrow at Union Bank. The transfer of the leasehold, however, was not handled through the escrow because Irvine set forth special requirements, and wished to handle the transfer themselves [RT 133-135]. Irvine's requirements were covered in the May 27, 1955 Agreement [RT 160, lines 10-18; 163, lines 12-22; 275, lines 5-19].

On or about June 2, 1955, the consent of Irvine was obtained to the transfer of taxpayer's business operation on the leased premises to Star Rock Products, Inc. [Ex. 7]. The escrow at Union Bank closed on June 7, 1955 [Ex. 9]. On June 17, 1955, the December lease was surrendered by taxpayer to Irvine and canceled and a new lease (the "June lease" herein) was executed naming taxpayer and Rodeffer as co-lessees [Amended Findings of Fact Nos. 17 and 20, CT 133-134; Ex. 8]. On July 9, 1955, an Assignment of Lease was executed, assigning the June lease to Star Rock Products, Inc. [Amended Finding of Fact No. 21, CT 134; Ex. 2]. On July 11, 1955, the Acceptance of the Assignment was executed on behalf of Star Rock Products, Inc. and on the same date the written consent of Irvine to said assignment was executed on behalf of Irvine [Amended Findings of Fact Nos. 22 and 23, CT 134; Ex. 2].

Star Rock Products, Inc. went into possession of the leased premises sometime after July 1, 1955, and commenced its operations thereon [Amended Finding of Fact No. 24, CT 134].

Rodeffer has never been and is not now obligated under any of the Agreements between the parties nor under the June lease to remove any material whatsoever from the sand and gravel deposit [Amended Finding of Fact No. 26, CT 135].

In summary, the taxpayer sold all of the assets of his sand and gravel business operation to Rodeffer. Although both taxpayer and Rodeffer intended the sale of the leasehold estate created by the December lease and of the machinery, equipment and leasehold improvements to be part and parcel of a single transaction, the sale, as a formal matter, was divided into two distinct parts: (i) an escrow for the sale of the machinery, equipment and leasehold improvements, as required by the Union Bank, and (ii) a lease cancellation, execution of new lease, and assignment thereof for the sale of the leasehold estate, as required by Irvine. The sale of the machinery, equipment and leasehold

improvements was completed on June 7, 1955, and the sale of the leasehold estate was completed on or after June 17, 1955.

The total purchase price paid by Rodeffer was Sixty Thousand Dollars ($60,000.00) cash plus a "royalty" of Three Cents (3¢) per ton of material produced and sold from the leasehold, allocated as follows:

(a) Fifty Thousand Dollars ($50,000.00) cash for the rock crushing plant;

(b) Seven Thousand Dollars ($7,000.00) cash for the truck scales;

(c) Three Thousand Dollars ($3,000.00) cash for the leasehold improvements; and

(d) Three Cents (3¢) per ton "royalty" for the leasehold estate.

SPECIFICATION OF ERRORS RELIED ON

1. The District Court erred in holding that the taxpayer retained an economic interest in the subject sand and gravel deposit [Amended Conclusion of Law No. 3, CT 135].

2. The District Court erred in denying taxpayer's Request for Special Finding [CT 137-138] and in failing, thereby, to find that the "royalty" constituted the purchase price for taxpayer's leasehold interest under the December lease.

3. The District Court erred in rendering judgment for the appellee and dismissing appellant's complaint with prejudice.

QUESTION PRESENTED

Whether a person has made an absolute sale and therefore has not retained an economic interest in a mineral deposit where he and the transferee intend a sale and purchase, where the operative documents use language of

sale and purchase, where the person has retained no property interest of any kind whatsoever in the deposit nor in the land containing the deposit, where he has retained no right to reacquire any interest in the deposit, where the transferee is under no obligation to extract any minerals from the deposit and where the person has received other consideration wholly unrelated to the withdrawal of material from the deposit.

ARGUMENT

SUMMARY OF ARGUMENT

The central issue in this case is whether the sums paid by Rodeffer to the taxpayer during the years in issue represent long term capital gain or ordinary income.[5]

The proper characterization of these receipts for Federal income tax purposes is dependent upon the economic substance and actual effect of the interrelated documents and agreements between the parties. If by these instruments the taxpayer sold his interest in the subject sand and gravel deposit, then the receipts are to be treated as long term capital gain.[6] If, however, taxpayer did not sell his interest in the deposit, then the receipts are ordinary income.

The difficulty lies in determining when there has been a sale by the taxpayer, and when there has been something less than an absolute sale; and the approach to this question in cases involving sand, gravel and other hard mineral deposits has been different from the approach in cases involving oil and gas deposits. In most

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5. The May 27, 1955 Agreement called for the payment by Star Rock Products, Inc. to taxpayer of three cents (3¢) per ton of material produced from the leasehold and sold by Star Rock Products, Inc. or its successor, labeling such payments as "royalties" [Ex. 5, para. 7(a)]. It is settled that the use of the term "royalty" to describe contingent deferred payments to be made to a taxpayer is of no significance in determining the ultimate character of the transaction. *Gowans v. Commissioner,* supra, 246 F.2d 448.

6. There is a subsidiary issue as to whether the taxpayer held his interest in the sand and gravel deposit for more than six months in order to qualify for long term capital gain treatment. This question is discussed at a later point in this brief (see discussion, infra, Part C).

of the cases, both those involving oil and gas and those involving hard minerals, the court states that the tax treatment to be given to the payments in question will depend upon whether the taxpayer sold his interest in the mineral deposit, or whether he retained an economic interest therein, reasoning that the two concepts (i.e., "sale" versus "retained economic interest") are mutually exclusive. In the oil and gas cases, the courts have first examined to see whether the taxpayer retained an economic interest and after making that determination, and based thereon, have concluded whether or not a sale took place. In the sand, gravel and hard mineral cases, on the other hand, the courts have first looked to see whether there has been a sale within the generally accepted meaning of the term and have then, based upon that finding, concluded whether or not the taxpayer retained an economic interest. Thus, in the hard mineral cases, the courts have not resorted to legal fictions, but have applied generally accepted principles in answering the question of whether there has been a sale.

The facts of this case are clear that the taxpayer sold his interest in the sand and gravel deposit to Rodeffer within the generally accepted meaning of the term, and within the meaning of Section 1222 of the Internal Revenue Code. Therefore, based upon the authority of the overwhelming majority of the Circuit Court, Federal District Court, and Tax Court cases involving sand, gravel, and hard mineral deposits, it must be held that the taxpayer did not retain an economic interest in the deposit, and thus the payments received by the taxpayer from Rodeffer are to be treated as long term capital gain.

THE TAXPAYER MADE AN ABSOLUTE SALE OF HIS INTEREST UNDER THE DECEMBER LEASE AND THEREFORE RETAINED NO ECONOMIC INTEREST IN THE SAND AND GRAVEL DEPOSIT

Whether deferred contingent payments based upon the quantity of material extracted from a mineral deposit (sometimes referred to as "royalties", see footnote[5],

> "In view of the interpretation we have given to the agreement [finding a sale] the cases involving the concept of 'retained economic interest', developed in connection with depletion deductions in transactions relating to oil, gas and mineral extraction, are clearly inapplicable. Nor should our conclusion in this case be understood as an indication that we have any views concerning analogous or similar transactions in the field of oil, gas and mineral extraction." [250 F.2d at 198]

In *White* the Court stated:

> "It is apparent from the quoted language [quoting from *Helvering* v. *Elbe Oil Land Dev. Co.*] that the Supreme Court has not intended that the Palmer v. Bender, supra, theory of economic interest is to govern all transfers of mineral interests involving future payments to be made from production." [311 F.2d at 402]

Turning, then, to an individual examination of the cases, we find the following:

1. *The Tax Court*

The most recent case before the Tax Court involving this issue was *Anne Pickard* (1966) 46 T.C. 597. In that case the court found a sale, stressing the fact that the transferee was under no obligation to extract any minerals, and relying heavily upon the authority of *Helvering* v. *Elbe Oil Land Dev. Co.* (1938) 303 U.S. 372, 82 L.Ed. 904, 58 S.Ct. 621

In *Jeanette O. Sager* (1962) T.C. Memo 1962-121, 21 T.C.M. 641, the court likewise found a sale, stating:

> "The petitioners . . . urge that the mere fact that a royalty has been retained does not result in the retention of an economic interest in the property, citing *Helvering* v. *Elbe Oil Land Co.* 303 U.S. 372 (1938). The petitioners contend, therefore, that by their deed

> they made an absolute sale of the minerals in the lands described in the deed and that the sums received on account of the deed should be treated as the sales price of the minerals. We must agree with the petitioners." [21 T.C.M. at 643]

Possibly the most lucid opinion of the Tax Court on this point was that in *Charles H. Remer* (1957) 28 T.C. 85, aff'd (8th Circuit 1958) 260 F.2d 337. Looking to the language of the contracting parties and the surrounding circumstances to determine the economic substance of what had been done, observing that the language used was one of conveyance in absolute terms with no reversionary interest retained, and emphasizing that the taxpayer had no right to control the production or to reacquire the leasehold under any circumstances, the Court said (at page 92) that if it were not for his contractual right to receive so much per ton, it would have had no trouble in holding that the taxpayer had transferred all his rights to the property and had not retained any economic interest; and despite the fact that the taxpayer retained a right to payment measured by production, the Court held that there was a sale.

Accord:

C. E. Johnson (1963) T. C. Memo 1963-321, 22 T.C.M. 1682

Maude W. Olinger (1956) 27 T.C. 93

2. *The First Circuit*

In finding a sale, the First Circuit has emphasized the fact that the payments received by the taxpayer were based upon fixed prices per unit extracted without reference to the prices received or profits, if any, made by the purchaser.

> "Turning then to the 'true substance' of the transactions between this taxpayer and those to whom he gave the right to remove sand and gravel from his property, it is evident that the taxpayer had no 'eco-

nomic interest' in the material taken from his property after its severance, for in every instance he sold sand and gravel for fixed prices per cubic yard without reference to the prices received or the profits, if any, made by the exploiters."

Linehan v. *Commissioner* (1st Cir. 1961) 297 F.2d 276, at 279

3. *The Second Circuit*

The Second Circuit, in finding a sale, has emphasized the intent of the parties and the language used in the instrument, and, as discussed above, has not even given lip service to the economic interest test, denying its applicability to sand and gravel cases.

Barker v. *Commissioner,* supra, 250 F.2d 195, 198

4. *The Fifth Circuit*

The Fifth Circuit, in finding a sale, has emphasized the intent of the parties, and the dominant purpose and essential character of the agreement between them as disclosed by all the evidence.

Crowell Land & Min. Corp. v. *Commissioner* (5th Cir. 1957) 242 F.2d 864, 866

In *Wood* v. *United States* (5th Cir. 1967), 377 F.2d 300, a case involving a "typical" mineral lease in which, naturally enough, it was held that there was no sale and that the taxpayer therefore retained an economic interest in the mineral deposit, the Fifth Circuit confirmed the import of its decision in *Crowell,* stating:

"It would appear, however, that strong emphasis [in *Crowell*] was placed upon the wording of the instrument as a contract of sale. The court reasoned that the instrument unambiguously revealed the true intent of the parties and that such intent was determinative of the issue before the court." [377 F.2d at 310-311]

And the Court further emphasized its point by quoting from *Crowell* as follows (in footnote 24 at page 311):

> "242 F.2d at 866:
>
> 'A bona fide sale was the intent of the parties and it was expressed in terms free from ambiguity throughout the instrument in the provisions and conditions it set out. Looking to the actual circumstances as well as the language of the contract of sale, there is no occasion or basis for resorting to legal niceties of interpretation to defeat the basic purpose and effect of the transaction.' "

5. *The Eighth Circuit*

Like the Fifth Circuit, the Eighth Circuit, in finding a sale, has emphasized the intent and purpose of the parties as evidenced by the terms and conditions of the operative documents between the parties, and has further stressed the fact that the transferee was under no obligation to extract any minerals.

> "It goes without saying that if this was a case where profits resulted from an ordinary sale of the property, the taxpayers properly reported the profits as capital gain. The written assignments were in the language of an absolute sale under warranty of title and contained no provision retaining any interest in the property so sold. The provision in the assignments for the payment of ten cents per ton on such concentrates as might be shipped imposed no obligation on the transferee to ship any ore, and the transferor retained no interest in the ore in place. The consideration to be paid was definite and absolute and the provision with reference to paying ten cents per ton for the ore shipped was simply a method of measuring the added consideration to be paid. The transferor had the bare right to payments measured by production. This did not, we think, result in the transferor retaining an economic interest in the property sold. It was merely

a covenant on behalf of the transferee to pay additional consideration to the transferor."

Commissioner v. *Remer* (8th Cir. 1958) 260 F.2d 337, at 339

In *Rabiner* v. *Bacon* (8th Cir. 1967) 373 F.2d 537, a case involving a "usual and simple form of mining lease" in which, as to be expected, it was held that there was no sale and that the taxpayer, therefore, had retained an economic interest in the mineral deposit, the Eighth Circuit confirmed its decision in *Remer,* stating:

"There is no conflict, however, in our opinion in *Remer* and here because in *Remer* there was involved the actual sale of two stockpile iron ore mining leases. The document in *Remer* was in the language of an absolute sale under warrant of title and contained no provision retaining any interest in the property sold. We held there that this constituted a sale of the leases and that the profits resulting therefrom were entitled to capital gains treatment." [373 F.2d at 539]

6. *The Ninth Circuit*

As stated above, this Circuit in *Gowans* was dealing with a somewhat unique set of facts. The Court found a sale, but stressed some of the unique aspects of that case in supporting its finding. The Court did emphasize, however, that the receipt by the taxpayer of other consideration in addition to the payments measured by production is of prime importance since an economic interest is not retained where the taxpayer receives other consideration wholly unrelated to sand and gravel withdrawals.

Gowans v. *Commissioner,* supra, 246 F.2d 448, 452

7. *The Tenth Circuit*

In finding a sale, the Tenth Circuit has looked to the intent of the parties and the true substance of the trans-

action, emphasizing the fact that the purchaser was not compelled under the contractual arrangements with the taxpayer to extract the minerals; and, as stated above, has denied the applicability of the economic interest test.

> "The Whites retained no investment or interest, economic or otherwise, in the minerals in place. The purchaser was free to remove the minerals, or not, as it saw fit. If there was production, the taxpayer was entitled to an additional payment. In this context the economic interest principle advanced by the United States is wholly a legal fiction."
>
> *United States* v. *White,* supra, 311 F.2d 399, at 402-403

It is true that the court in *White* was called upon to determine the tax treatment to be given a downpayment received by the taxpayer under a mineral deed, and expressly stated that its decision in favor of the taxpayer as to the downpayment would not necessarily control the tax treatment of possible future royalty payments under the mineral deed. Nonetheless, the Federal District Court which was subsequently faced with the question of the tax treatment to be given such royalty payments held that the rationale of the Tenth Circuit in *White* was equally applicable to the royalties, stating:

> "In the case at bar the taxpayers divested themselves of every incident of ownership of the minerals. The Whites could not have compelled the grantees to mine the ore. The decision to proceed or not was entirely that of Denver-Golden under the terms of the deed. Thus, there was no reversionary interest in the Whites whatever, and not a single stick in the so-called bundle of rights remained in them. It follows that there was no such interest, economic or otherwise, in the Whites which would justify the subjecting of these proceeds to ordinary income less depletion.

"Accordingly, we conclude that the ten per cent interest clause is to be viewed as a deferred payment provision."

White v. *United States* (D.C. Colo. 1966) 254 F.Supp. 894, at 896-897

9. *Summary of Decisions*

From the foregoing it is evident that in the solid mineral cases, the courts, while sometimes giving lip service to the economic interest test carried over from the oil and gas depletion cases, have really approached the problem as one involving the general question of whether there has been a "sale", and have rested their decisions upon combinations of such indicia as the intent of the parties (*Sager, Remer, Olinger, Johnson, Barker, Crowell* and *White*), the language used in the instruments of transaction (*Sager, Remer, Olinger, Johnson, Barker, Crowell* and *Gowans*), the absence of a reversion or right to reacquire the deposit or any interest therein (*Remer, Olinger*), the absence of an obligation to extract minerals (*Remer, Pickard,* and *White*), the basis for determining the amount of "royalty" *(Linehan),* and the receipt of other consideration wholly unrelated to the withdrawal of minerals (*Gowans*).

B. All of the Indicia of Sale Are Present in This Case

It was the intent of taxpayer to make an absolute and outright sale of his leasehold estate under the December lease to Rodeffer as a part of the sale of his entire sand and gravel business operation, and it was the intent of Rodeffer to buy said leasehold estate [RT 183, lines 23-25; 184, lines 1-11; 130, lines 8-23; 135, lines 12-25; 136, lines 1-5; Exs. 4 and 5]. Most significantly, the "royalty" provision was intended by the parties as a method of payment for the taxpayer's leasehold estate on a deferred basis, and in lieu of a lump sum cash payment. [RT 141, lines 4-25; 142, lines 1-18]. It was the dominant purpose of the various instruments executed by the parties to carry out such sale and purchase; and the essential character of

the transaction was that of a sale and purchase of taxpayer's entire sand and gravel business operation including his leasehold estate created by the December lease. The surrender and cancellation of the December lease, execution of the June lease, assignment thereof, and the opening and closing of the bulk sale escrow, taken together, constituted merely the formal steps by which the sale and purchase transaction was accomplished, and were nothing more than component parts of a unified transaction [RT 133, lines 15-25; 134-135; 160, lines 4-25; 161, line 1].

Under a similar set of facts, the Tax Court in *Samuel D. Miller* (1967), 48 T.C.—, No. 62, determined that the cancellation of a sublease and the assignment of a prime lease by means of separate documents, were merely formal steps towards the attainment of the parties' business objective, and thus held the government to be wide of the mark in maintaining that the tax consequences of the transaction should depend upon its form rather than its substance. The issue in that case was whether an amount of money received by the taxpayer should be treated as long term capital gain from the sale of a leasehold, and the Court was faced with a situation where the formal mechanics of the transaction did not favor the taxpayer. Nevertheless, the Tax Court held for the taxpayer, stating:

> "We place little importance on the fact that the sublease cancellation and the prime lease assignment were effected by separate documents with the $32,000 payment termed consideration for the sublease cancellation. Both of the documents were executed on the same day and we view them as unified components of the same transaction. We are concerned with the substance not the form. The sublease cancellation was merely supplementary to the attainment of Seaway's business objective.
>
> * * *
>
> "We view the separate documents involved as constituting a unified transaction, and thus the payment constituted compensation for Seaway's acquisition of

petitioner's leasehold interest in the property. This interest was the only interest that petitioner had in the property and all that was important to the parties." [CCH Tax Court Reporter, at 2643-2644]

Since it was the intent of the taxpayer and Rodeffer to engage in a sale and purchase transaction, since the dominant purpose of the various documents was to carry out such transaction, since the taxpayer retained no reversionary interest or right to reacquire the lease, since taxpayer received, in addition to the "royalty", other consideration wholly unrelated to the extraction of sand and gravel, namely, the sum of Sixty Thousand Dollars ($60,000.00) in cash, and since Rodeffer never has been and is not now obligated to produce any sand, gravel or other earthy substances whatsoever from said leasehold estate, the transaction must be viewed as a sale and it must be held that the taxpayer retained no economic interest in the sand and gravel deposit.

C. Taxpayer Had a Holding Period of More Than Six Months for the Leasehold Interest Which He Sold

Since the taxpayer sold his interest in the deposit and, therefore did not retain an economic interest therein, he is entitled to treat the three cents (3¢) per ton royalty as long term capital gain under either Section 1221 or Section 1231 of the Internal Revenue Code, provided he had a holding period of more than six months for the leasehold interest which he sold.

It is undisputed that taxpayer's leasehold estate under the December lease was either a capital asset as defined in Section 1221, or property used in his trade or business as defined in Section 1231(b)(1). It is likewise clear from the amended findings of the District Court that the taxpayer held his leasehold estate under the December lease for more than six months. [Amended Findings of Fact Nos. 16 and 20, CT 133, 134] Thus, the "royalty" qualifies for long term capital gain treatment unless it can be said that it was not taxpayer's interest under the December lease which was sold to Rodeffer.

The government argued in the District Court that it was taxpayer's interest as a co-lessee under the June lease, not taxpayer's interest under the December lease, which was sold to Rodeffer and for which Rodeffer agreed to pay the "royalty". Thus, goes the argument, since it is clear that taxpayer's holding period for his interest as a co-lessee under the June lease was less than six (6) months, the "royalty" cannot under any circumstances qualify for long term capital gain treatment.

The taxpayer requested, but was denied, a special finding designed to make clear precisely which leasehold interest it was that the taxpayer sold and that Rodeffer purchased and for which Rodeffer agreed to pay the "royalty". It was error for the District Court to deny taxpayer's request, for the record is clear that the only interest in the deposit which the taxpayer owned and could therefore sell at the date of the May 27, 1955 Agreement was his leasehold interest under the December lease. It was this interest alone which Rodeffer wished to buy since it was the "key" to the entire deposit. Therefore, it was taxpayer's interest under the December lease which was sold, and the "royalties" constitute the consideration for taxpayer's interest under that lease for which he had a holding period of more than six months.

Rodeffer's testimony was positive and clear that it was taxpayer's rights under the December lease which he wanted to buy, and he didn't care whether he obtained those rights directly, by means of an assignment of the December lease, or indirectly, through the surrender by taxpayer of that lease to Irvine, followed immediately by the creation of the June lease, and consequent assignment thereof [RT 134, lines 22-25; 135; 160, lines 4-18]. Rodeffer testified that if a person had a lease to Area "A" (referring to Exhibit J which showed Area "A" to be that covered by the December lease), he could get any additional acreage that he needed.

> "My understanding was that if you held Area A you would get any additional land as time went on from Irvine. That was the key part of the deposit.

"Without A you got nothing else. With A you got it all." [RT 153, lines 22-25; 154, line 1]

Again in response to the question whether he would have been willing to purchase Area "A" without the availability of the additional area covered by the June lease, Rodeffer testified:

"Yes, we would have. As it turned out it wasn't necessary, but we would have been willing to." [RT 154, lines 16-17]

Irvine, however, chose not to permit a simple assignment of the December lease, followed by an amendment to include the additional acreage which Rodeffer wanted. No reasons were given. Rodeffer testified that Mr. Spurgeon of The Irvine Company simply dictated the manner in which the transaction was to be carried out, and that was that [RT 160, lines 10-25; 161, line 1]. Since the form of the transaction didn't make any difference to the taxpayer or Rodeffer so long as their business objective could be achieved, they were pleased to comply [RT 135, lines 8-11].

In the District Court the government made much of the fact that the December lease was not actually assigned to Rodeffer; rather, it was surrendered and canceled. This Court has held, however, and it is settled, that amounts received by a lessee from a third party as consideration for the lessee surrendering his lease to the lessor for cancellation, will be considered as amounts received from the sale of such lease. Therefore, if the lease is a capital asset in the hands of the lessee, or an asset used in his trade or business, and has been held by the lessee for more than six months, the lessee will have a long term capital gain.

Metropolitan Bldg. Co. v. *Commissioner* (9th Cir. 1960) 282 F.2d 592

See also,

Commissioner v. *Ferrer* (2nd Cir. 1962) 304 F.2d 125, 130-133

Samuel D. Miller, supra, 48 T.C.—, No. 62

In *Metropolitan* the question presented involved the owner of real property, his lessee, and a sublessee. The sublessee wished to enter into a desirable arrangement directly with the owner and to this end to eliminate the intervening interest of the lessee-sublessor. He paid a sum of money to the lessee, in consideration of which the lessee surrendered his lease to the owner, his lessor. The court was called upon to decide whether, despite its form, the transaction should be regarded as a sale by the lessee of of his lease to the sublessee, and the sum so paid to him therefore treated as long term capital gain. In holding for the taxpayer, the court disregarded entirely the formal distinction between an assignment of a lease to a third party, and the surrender of a lease for cancellation in consideration of an amount paid by the third party, stating as follows:

> "In the case before us, the sums paid to Metropolitan . . . were paid for the purchase of Metropolitan's entire leasehold interest. * * * The giving up of a lease by a tenant fits the legal requirements of a sale or exchange under [the Internal Revenue Code] and a gain realized by the tenant on such a transaction is capital gain." [282 F.2d at 594]

CONCLUSION

It is evident from the foregoing that the taxpayer herein sold his leasehold interest under the December lease to Rodeffer, that his interest under the lease constituted an asset used in his trade or business held for more than six months, and that therefore the amounts paid to taxpayer by Rodeffer during the years in issue should be treated as gain from the sale of a capital asset held for more than six months. It is respectfully submitted, therefore, that the judgment of the District Court be reversed, and the cause remanded with instruction to enter a judgment in favor of the Appellants.

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December 8, 1967

APPENDIX

STATUTES AND REGULATIONS INVOLVED

1. Section 1221 of the Internal Revenue Code of 1954 provides in pertinent part:

> "For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
>
> "(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
>
> "(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business. . . ."

2. Section 1222 of the Internal Revenue Code of 1954 provides in pertinent part:

> "For purposes of this subtitle—
>
> * * *
>
> "(3) LONG-TERM CAPITAL GAIN.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income."

3. Section 1231 of the Internal Revenue Code of 1954 provides in pertinent part:

> "(a) GENERAL RULE.—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business . . . exceed the recognized losses from such sales [and] exchanges, such gains and

losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months.

* * *

"(b) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS.—For purposes of this section—

"(1) GENERAL RULE.—The term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

"(A) property of a kind which would properly be includable in the inventory of the taxpayer if on hand at the close of the taxable year,

"(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, . . ."

4. Treasury Department Regulation Section 1.611-1(b)(1) provides in pertinent part:

"An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . . and secures, by any form of legal relationship, income derived from the extraction of the mineral . . . to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit . . . does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production."

TABLE OF EXHIBITS

Plaintiffs' Exhibits	For Identification*	In Evidence*
1	21	28
2	28	30
3	45	47
4	48	51
5	57	58
6	131	133
7	136	137
8	138	139
9	182	183
10	198	205
11	205	207

Defendant's Exhibits	For Identification*	In Evidence*
A	66	66
B	87	
C		87
D	88	88
E	88	89
F		92
G		103
H	105	106
I	147	149
J	149	149
K	168	171
L	212	
M	240	241
N	340	

*Page references are to the Reporter's Transcript of Proceedings.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

PAUL FREDERIC MARX, *Attorney*